COST-BASED BUDGETING — HISTORICAL DEVELOPMENTS AND IMPLEMENTATION

PAUL L. FOSTER

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by

Paul L. Foster

Lieutenant Commander, S. C.
U. S. Navy

Bachelor of Science
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Northwestern University

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Thesis directed by

Arlin Rex Johnson, Ph.D.
Professor of Business Administration

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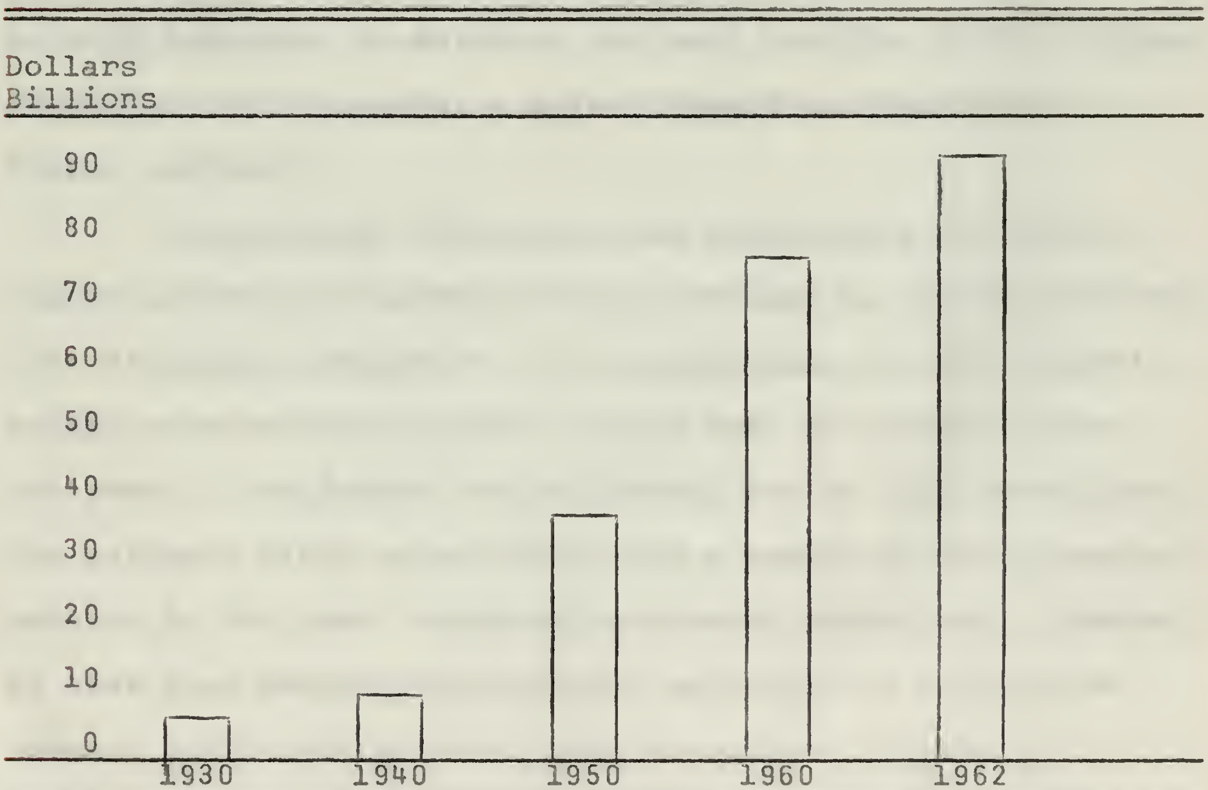
INTRODUCTION

Improvements in financial management in the United States Government were necessitated after World War II by the tremendous growth in the size and scope of the Government's operations. Table I shows the rapid growth of Federal expenditures since 1930:

TABLE 1

FEDERAL EXPENDITURES SINCE 1930



The Fiscal Year 1964 budget submitted by the President to the Congress is $98.8 billion. The United States Government is by far the largest "business" in the world. Its vast activities are administered by over fifty-five different Government agencies, and counting the armed forces, it employs over five million people. Contrast this with AT&T which is the nation's largest private employer with a payroll of approximately 600,000 people, or with General Motors whose volume of sales, the nation's largest, which are less than 1/8 the size of the FY 1964 Federal budget.

The above statistics on the size of the Federal Government's operation make abundantly clear why it is vitally important to maintain the best possible fiscal control. Budgeting is, of course, a major element in government fiscal control.[1]

Formulating, directing, and controlling the Federal Budget has been considered the key process in sound government-wide financial management. In consequence, the Government's budget process has received a great deal of attention over the years. The Budget and Accounting Act of 1921 established the nation's first budget system as a result of the pressures created by the then expanding government operations. However, at that time Federal expenditures were only $3 billion per annum.

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[1]Maurice H. Stans, "Current Improvements in Federal Budgeting," The Journal of Accountancy, Vol. 107, No. 5 (May, 1959), p. 32.

With the enormous expansion of government operations and the resulting growth of the Federal budget during the past two decades there have been some major improvements in the Federal budgeting process. The most important improvements since 1921 have been:

1933--The apportionment process for appropriated funds was transferred to the Bureau of the Budget.

1939--The Bureau of the Budget was transferred to the Executive Office of the President.

1945--The Government Corporation Control Act established budgeting controls over government corporations.

1948--The Joint Accounting Improvement Program was started.

1950--The Budget and Accounting Procedures Act of 1950, provided for a budget presentation by functions and activities, and gave the President discretion as to the details. The general accounting requirements in this Act did not specify accrual accounting; however, these requirements could not be effectively met without the use of the accrual basis. Also, despite the discretion it gave the President on the budget side, the Congress amended it in passage to provide for the continued presentation of object class data as in prior year's budgets.

1956--Public Law 863 had the effect of more specifically requiring the use of cost-based budgets and accrual accounting.

Cost-based budgeting and accrual accounting are major improvements in the conduct of financial management in the government and certainly are key developments resulting from legislation passed by the Congress to strengthen and improve government-wide financial management. The development of cost-based budgeting and accrual accounting can be traced in two general phases. The first phase covered development of budgeting to establish program classification and to bring out the costs of performance. This phase covered the period 1950-55. It followed the first Hoover Commission's performance budgeting concept, which was to bring out the costs of performance. Phase two started with the enactment of Public Law 863 in 1956, and it placed emphasis on developing accrual accounting and costs for budgeting under the term cost-based budgeting.

Before 1950, the objective in Federal budgeting was to present the budget in terms of object class and to show the obligational requirements for those objects. The financial control was exercised in the same fashion as budget formulation and review, by object class and obligations.

In the period 1950-56, the objective in Federal budgeting was to present and control the budget in terms of activities and programs, and to show the cost of performance. Actually, during this period only programs and activities were established. The requirements were stated and financial control was still exercised on the basis of obligations in

lieu of cost of performance.

Starting in 1956, due to the slow progress which had been made in developing costs of performance, emphasis was placed on developing agency accounting systems which would provide the necessary cost data. Thus, the second phase in the development of cost-based budgeting emphasized accrual accounting and the use of a cost-based budget.

The purpose of this thesis is to examine the evolution of cost-based budgeting in the Federal Government to determine if it has been effective in fulfilling the objectives intended. This examination will include a definition and description of cost-based budgeting and a detailed historical summary of the events leading to the adoption of this concept. Cost-based budgeting will be discussed from the standpoint of why it was necessary and how it has been implemented. Problems encountered in connection with implementation will be discussed, and finally the conclusions will outline the extent to which cost-based budgeting has been effective in fulfilling its objectives.

CHAPTER I

COST-BASED BUDGETING

The budget process in the Federal Government, including the formulation, review, and execution stages, is one of the most important elements in the financial management of the United States Government. The budget is the heart of this system and should be defined at the beginning of this thesis.

Budgets and Budgeting

The word "budget" originally meant the money bag or the public purse, which served as a receptacle for the revenue and expenditure of the state.[1] Historically, the budget was a financial document prepared by a government to relate anticipated revenues to planned expenditures of a fiscal period, as a basis for adjusting income to outgo. Now, with the wider use of budgets, a distinction must be drawn between budgets and budgeting. Herman C. Heiser defines the budget as " . . . an over-all 'blueprint' of a comprehensive plan of operations and actions, expressed in financial terms."[2]

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[1]Jesse Burkhead, Government Budgeting (New York: John Wiley and Sons, Inc.; London: Chapman & Hill, Limited, 1956), p. 2.

[2]Herman C. Heiser, Budgeting, Principles and Practices (New York: The Ronald Press Company, 1959), p. 3.

He defines budgeting as "the preparation of a budget and its fullest use, not only as a device for planning and coordinating, but also for control."[3]

In the Federal Government, the budget represents the plan of operations for a fiscal year expressed in financial terms. Budgeting is the medium through which agencies determine needs, request funds, and obtain the financial authority from Congress, in the form of appropriations, to carry out their operations.

Cost-Based Budgets

How does a cost-based budget differ from an obligation-type budget? Prior to 1951, the Federal Government used an obligation-type of budget. Agency requests for appropriations were made to show the amount of obligational authority needed to purchase goods and services to carry out their operations for the fiscal year. In the execution phase of the budget the agencies financial management systems were developed, primarily, to control in terms of objects of expenditure to insure against overobligating appropriated funds. These agency financial systems generally were adequate for compliance with the requirements of law, but they did not always reach their full potential as a management control device because of their failure to develop significant operating information of a financial nature.[4]

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[3] Ibid., p. 4.

[4] Bureau of the Budget, Cost-Type Budget Presentations for Appropriation Accounts, July 1958, p. 3.

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As opposed to the obligation-type of budget, the cost-based budget requires that an agency set forth the major work programs which are measurable in terms of some end product or accomplishment, and identify the cost of those programs so that some judgment can be rendered on the value of the program in relation to its cost. Cost-based budgeting uses cost both as the basis for budget formulation, and as a control device in budget execution. In budget formulation, the estimated amount of work to be performed under a program is developed by using the cost experience of the agency (including unit costs where appropriate), adjusted for price changes and all other pertinent factors. The budget thus becomes a financial plan which brings into focus all of the resources available for the performance of the work, and identifies the resources to be carried over at the end of the year.

It can be seen, then, a cost-based budget is comprised of a performance element and a cost element, both of which are described below:

> Performance (or Program) budgeting recognizes the values of budgeting (and accounting) in terms of distinct functional programs, each of which had some measurable end-product. This device focuses attention on the work program to be undertaken and the results to be achieved. It thereby places each in relationship with all other programs insofar as its contribution to the total agency is concerned. On this basis, a proper evaluation of its scope can be made. Performance budgeting is in contrast to the traditional approach wherein budgets emphasized the things to be acquired for organizational components of the agency.

> Cost budgeting recognizes the value of budgeting (and accounting) in terms of cost of goods and services consumed in the conduct of each of the functional programs established under the performance budget, irrespective of when the goods or services are ordered, paid or received. This device focuses attention on the actual cost of work accomplished. These costs are reconciled in total to the amount of obligational authority required by estimating the change in unused resources which will take place during the year. Cost-budgeting is in contrast to obligation-type budgeting wherein estimates reflect obligations for orders placed, rather than the cost of services or goods consumed, and are classified according to the object involved (travel, rents, supplies) rather than the functional program in which the object will be used.[5]

Today the concepts of cost-based budgeting and performance budgeting have in effect been merged through the amendment of the Budget and Accounting Procedures Act of 1950 by Public Law 863.[6] It should be noted, at this point, that under one interpretation the performance concept can be used with the obligation-type budget whereby obligations are apportioned to functional programs. This system lacks the feature of cost-based budgeting which reflects the cost of goods consumed rather than the orders placed. The

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[5] Preliminary Draft of Budget Training Materials. Prepared by the Budget Officers' Conference, Reproduced November, 1956, p. 2.

[6] The Budget and Accounting Procedures Act of 1950, authorizes the preparation of a budget with financial information in terms of functions and activities of the government. Public Law 863 requires the use of cost-based budgets and accrual accounting to develop the cost of performance.

Department of Defense is the most notable example of this arrangement, as DOD still operates under the old obligational-type budget with identifiable functional programs. Until all of the agencies complete their conversion to cost-based budgeting, there will be budget appropriation requests prepared as cost-based budgets and as obligation-type budgets showing functional programs.

The conversions to cost-based budgets are not to be considered as ends in themselves; they are only generally indicative of the progress being made throughout the government toward management use of better data. The cost-based budget requires an integrated system which through coordinated accounting, reporting and budgeting practices, provides adequate control of both funds and costs and is a basis for measuring performance against established goals.[7]

Accrual Accounting

Accrual accounting has been discussed as being fundamental to the use of a cost-based budget. An accrual accounting system reflects the resources available to an agency, the receipts of goods and services, the use of resources in relation to work performed during a particular time period, and the liabilities of an agency. It incorporates monetary and property accounting procedures to provide for

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[7] U. S. Congress, Senate, Document No. 11, Financial Management in the Federal Government, 87th Congress, 1st Session, February, 1961, p. 96.

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appropriate recognition in an agency's accounts of property, equipment, and inventories of materials and supplies. This is the basis for financial controls which are consistent with management responsibilities. It provides broad fund controls in terms of limitations on obligations, and more detailed controls in terms of specific costs attributable to an agency's program. This is in contrast to the generally used accounting system in government which may reflect the availability and status of funds, but does not show all resources on hand, nor actual use of these resources.

Accrual accounting is the basis for developing accurate and meaningful cost data on the operations of an agency. The additional information developed in an accrual accounting system is valuable for evaluating performance, financial planning, control of costs of operations, and for the development of budgetary requirements. For management it enables more effective controls as it gives data on all available resources and the actual cost of program performance during a given period. Program costs can thus be analyzed and compared with planned forecasts or the costs of similar operations, and can be refined into unit costs, where such information may be significant. This type of information provides a better basis for decisions, and with respect to budgeting, an accrual accounting system furnishes the most complete disclosure of the costs of an agency's programs and their financial status, including undelivered orders,

inventories on hand and other resources. Accrual accounting therefore provides the best basis for determining and evaluating the financing requirements of planned programs.[8]

Advantages of Cost-Based Budgeting

Cost-based budgeting provides agency management and Congress with information so they can review the total resources on hand, on order, and required. It does not limit the budget formulation and review process only to the funds needed for new purchases and coming operations stated as obligating authority. A cost-based budget identifies, in terms of the goods and services consumed by each activity, the costs of the program planned by the agency. It discloses the inventory of goods on hand which have been obtained from prior years' appropriations. It, also, shows to what use and to what extent the inventories will be employed in the budgeted accounting period. The resources on hand usually include inventories of supplies and materials, and orders for goods and services not yet received, but which have been recorded as obligations. The cost-based budget shows the obligating authority required to place orders for goods and services needed to accomplish the planned program and maintain the resources on hand at the level necessary to support planned

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[8] Treasury Department, Bureau of the Budget, and General Accounting Office, The Joint Program for Improving Accounting in the Federal Government, May 1958, pp. 13-15.

operations.[9]

The advantages of a cost-based budget are described by Mr. Karney A. Brasfield, Assistant to the Comptroller General, in his testimony as a witness before the Government Operations subcommittee on this subject. Mr. Brasfield gave the following four important advantages:

> Cost data (based on man-days worked, materials used, etc.) can be directly related to work accomplished in prior periods and offers a basis for comparison with proposed plans.
>
> A proposed work plan (budget) stated in terms of costs (resources to be consumed) can be realistically evaluated against new money requirements taking into consideration inventories and other resources on order and on hand at the beginning and those resources to be carried over for use in subsequent periods.
>
> Cost data can be related to the responsibilities of each segment of the organization and its accomplishments.
>
> Cost budgeting permits the maximum opportunity for the exercise of management initiative and precludes need for rigid fund control (on a detailed basis) with its deadening influence.[10]

Cost-based budgeting effectiveness as a financial management tool varies with the type of program to which it is applied. The cost-based budget is of the greatest benefit to the manager in programs where there are long-lead time construction or procurements involved, because it identifies the resources which are being carried over from one year to

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[9] Document No. 11, Financial Management in the Federal Government, op. cit., pp. 95-96.

[10] U. S. Congress, House of Representatives, Subcommittee of the Committee on Government Operations, Budget and Accounting Hearings, 84th Congress, 2nd Session, May 21, 22, June 12 and 19, 1956, p. 32.

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the next. In addition, long-range plans can better be evaluated because the accrual basis of accounting identifies the uses of resources in relation to the time period in which they are consumed. In agencies where the programs are not of a long-range nature and where there is little carry over of resources, the benefits come from more precise budget and accounting practices which lead to greatest economy and efficiency.[11]

Annex A is a discussion of the Atomic Energy Commission's successful experience with cost-based budgeting. It is included as an example of a major agency of the government which has benefited from program and financial operations on a cost-based budgeting basis.

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[11] *Ibid.*, p. 96.

CHAPTER II

HISTORICAL DEVELOPMENTS IN COST-BASED BUDGETING PHASE ONE

The Performance Budget

Former President Hoover is given credit for inventing the term "performance budget" to give impact to a new and different method of improved Federal budgeting. The expression, as a description of the type of budget which Mr. Hoover had in mind, may be questioned by some as not being totally descriptive; however, no other single recommendation of the first Hoover Commission has had more far-reaching effect nor resulted in more constructive efforts for reform and improvement in the field of government management.[1]

Actually, performance budgeting is not new, as it has been around a long time. There are references to performance budgeting back as far as fifty years ago, when it was applied to certain activities of the Borough of Richmond in New York City. Frederick C. Mosher, in his book on program

[1]Frederick C. Mosher, Program Budgeting Theory and Practice (New York: American Book-Stratford Press, Inc., 1954), p. 78.

budgeting, made reference to this when he stated that some government agencies and a number of local governments were already operating on a performance budget system which approximated program or performance budgeting before the first Hoover Commission. He gave some early references to performance budgeting, as follows:

> . . . the first experiment in program budgeting, then known as "cost-data" budgeting, was applied to the public works activities of the Borough of Richmond in New York City in 1912. The recent article by Catheryn Seckler-Hudson on "Performance Budgeting in the Government of the United States" . . . likewise stresses that program budgeting is not a new idea in the United States. She mentioned among the predecessors of the performance budget proposal the report of Taft's Commission on Economy and Efficiency, and the practices of the Federal Departments of Interior and Agriculture, the State of California, and "progressive cities". . . . Of the latter, perhaps the best known is Richmond, Virginia, about which John A. Donaho, then its budget director, was principally writing in his article on "The Performance Budget". . . . On the Federal level, the TVA has long been known for its program budget system, which was well described in a pamphlet by Donald C. Kull. . . .[2]

The First Hoover Commission

The need for budgetary and accounting reforms were evident to the First Hoover Commission in their studies from 1947-49, and were the subject of their second report on budgeting and accounting. The recommendations received the wholehearted support of the President and the executive departments of the government, and almost universal support in

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[2] *Ibid*., p. 79.

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Congress and from outside government financial consultants and experts.

The following statements of the Honorable Glenard P. Lipscomb, representative from California, in the hearings before the Subcommittee on Government Operations House of Representatives, indicate the need for budgeting and accounting reforms based on the adoption of cost-based budgeting and accrual accounting, as well as the other reform recommendations of the Hoover Commission:

> It would seem that the starting point is the development of sound, accurate, meaningful, useful fiscal data which could be generated from an adequate and efficient budget and accounting system. Until we put the fiscal operations of the Government on such a system, all of the desirable procedural changes in the world will have only minimum effectiveness.
>
> I strongly urge the enactment of H. R. 9402 or a comparable version of a revised bill because I believe it will make possible more effective congressional control over Government expenditures. It does this by providing for cost-based accounting and cost-based budgeting throughout the government.
>
> The General Accounting Office, in its comments on H. R. 9402, points out that the primary advantage of budgeting on a cost basis to both the management officials in an agency and the Congress is that the total resources to be used (on hand, on order, and to be procured) are reviewed rather than limiting the budget review process to primary consideration of programs and projects for which new appropriations are being considered.[3]

In support of the need for budgetary and accounting reforms, Representative Clarence J. Brown of Ohio, stated:

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[3] U. S. Congress, House of Representatives, Subcommittee on Government Operations, Budget and Accounting Hearings, 84th Congress, 2nd Session, May 21, 22, June 12, and 19, 1956, p. 32.

> We talked with a great many public officials and made a study of this problem. We found there was no question that reform was needed in both budgeting and accounting practices in the Federal Government; and that there was an opportunity to save a great deal of money, and to get greater efficiency in the conduct of the public business.[4]

Some of the major defects that the first Hoover Commission found in the budget system were described by Mr. M. C. Conick, a Certified Public Accountant representing the Chamber of Commerce, when testifying before the Subcommittee on Government Operations. He stated that the budget system had four serious defects:

> The lack of dependable information concerning overall costs of new programs and projects.
>
> Lack of enough independent information concerning the actual necessity for the funds requested.
>
> The fact that Congress has no control over actual expenditures, once the money has been appropriated.
>
> The fact that budget presentations, supported by charts, tables, and other graphic material, reflect emphasis not on cost consciousness, or the necessity for the proposed expenditure, or minimum requirements, but primarily on the petitioner's intense desire to get the cash out of the Congress.[5]

The basic need of the agency, the President, and Congress is the development of sufficient factual information for intelligent decision making. The agency is the locus

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[4] *Ibid*., p. 42.

[5] *Ibid*., p. 92.

for the development of this information and it can be developed better and faster if information is based on a sound financial management system. Cost-based budgeting and accrual accounting provide the basis for such a system by relating accomplishments and future work to costs in terms of total resources consumed and to be consumed, as well as materials on hand and the funds required for operations by considering the interrelationship of these factors.

The first Hoover Commission Report strongly recommended that the U. S. Government should adopt the performance budget. It would better show the programs of the government and what they would cost, as opposed to the previous techniques that were used, which presented the budget primarily in terms of object of expenditures and the obligations that were intended to be incurred for these objects of expenditures. The report stated:

> There are serious weaknesses in the internal operations of the Federal Government in the Fiscal field. These weaknesses penetrate into the heart of every governmental transaction. The President's budget, as submitted to the Congress annually, does not indicate accurately what the costs of each activity will be over the coming year; and the Government's accounting system, outmoded and cumbersome, does not indicate what was accomplished with the money spent in the past year.[6]

This comment of the first Hoover Commission made reference to lack of actual cost of operations, and the

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[6] Document No. 11, Financial Management in the Federal Government, op. cit., p. 53.

inability of the obligation-type budget system to tie expenditures to programs or functions of the government. Thus, the single most important recommendation in the report called for a new budgetary concept based on functions, activities, and projects, which was designated as a performance budget.

In justification of its recommendation, the first Hoover Commission stated that a performance budget would expedite action by Congress on budget estimates, would assure more revenue figures for the forthcoming budget period, and would provide more complete agency estimates for the Congress.[7]

It is necessary to continue to explore the background of the development of the budgetary and accounting reforms which resulted in cost-based budgeting fully to understand why the changes were necessary. To develop this line of thought further, it is pointed out that the first Hoover Commission declared that the new performance budget concept would answer two major questions: first, from the viewpoint of budgeting, "What is the money wanted for?" and, second, from the viewpoint of accounting, "What do the taxpayers get for it?"

In support of these questions, the Commission stated:

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[7] *Ibid.*, p. 54.

> These two questions lie at the root of any fiscal system. The present budgeting and accounting systems of the Federal Government either does not supply the answers to these questions, or supplies "half answers"; a good system would supply the right answer.
>
> Budgeting and Accounting go hand in hand. Sums budgeted in advance are subsequently accounted for as obligated and spent. The activities are the same and the accounts themselves must be the same. Only by making comparisons between similar activities, and between the same activity in one year against another year, can efficiency be tested. Only by making the head of each activity financially responsible for all the costs of his program, can he be held to account. Only by modernizing the Federal system of budgeting and accounting will it be possible to tell exactly how much any single program or project is costing. The Federal Government must be able to assess results intelligently.[8]

The government-wide development of performance budgeting was sporadic, and it was the contention of the first Hoover Commission that:

> the program approach in the Federal budget was subordinated and obscured in a welter of appropriation items, which followed no logic other than the accident of history.[9]

More particularly, it found that the primary emphasis in the Federal budget was upon organizational units, making it virtually impossible to correlate appropriations with program costs; and upon objects or items of expenditure, swamping the purpose of expenditures under an ocean of

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[8] Ibid.

[9] Mosher, op. cit., p. 79.

meaningless detail.[10]

The fundamental concept behind the first Hoover Commission Recommendation for a performance budget was to provide for a better presentation to the Congress, and better consideration, evaluation, and action by Congress of the appropriation requests of the agencies. With this, of course, they anticipated a much better development and formulation of the budget in the agencies, because if the point of budget development and formulation was on what was to be done, this would bring the program planners more into the budget process. This would put officials at the top levels in the agencies and legislative branch in a better position to judge whether or not they should support a request to the extent of the funds requested.

Performance budgeting was adopted in the budget for fiscal year 1951. In the FY 1951 budget, the first step toward full implementation of cost-based budgeting (a performance budget based on the cost of goods and services to be consumed) was made when the Atomic Energy Commission and the Bureau of the Mint in the Treasury Department presented their appropriation requests in terms of costs by activity.

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[10] Ibid.

CHAPTER III

HISTORICAL DEVELOPMENTS IN COST-BASED BUDGETING PHASE TWO

The Cost-Based Budget and Accrual Accounting

In 1956, public law 863 brought about the marriage of the performance budget and the cost-based budget, by establishing in law basic principles for government budgeting and accounting, and the development and use of cost information. It is an expression of intent on the part of Congress, which together with the direction provided by the President's statement on policies of the executive branch, provides a firm basis for moving forward in the improvement in the general field of financial management in the government.[1] This legislation represents one of the most important milestones in the development of financial management in the Federal Government.

Inasmuch as the enactment of Public Law 863, is the authority for cost-based budgets and accrual accounting, which starts the second phase of cost-based budgeting, it is

[1] Bureau of the Budget, Improvement of Financial Management in the Federal Government, October, 1956, p. 6.

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essential that the developments leading up to the passage of this legislation be discussed.

Public Law 863, grew out of the recommendations of the Second Hoover Commission. The Second Hoover Commission report on budgeting and accounting directed its major recommendations toward providing effective control over expenditures by the executive branch and by Congress. A brief summary of the work of the Second Hoover Commission was described as follows:

> The second Hoover Commission report on budgeting and accounting was submitted to Congress in June 1955. It contained 24 recommendations for budgeting, accounting and auditing practices, financial and performance budgets, financial organization, and related matters. The report proposed expansion of the Bureau of the Budget and the creation of an Office of Accounting in order to enable the more effective discharge of the Bureau's managerial, budget, and accounting functions, on the premise that the strengthening of the Bureau of the Budget has a direct bearing on the leadership within the executive branch toward fulfillment of the Commission's recommendations.
>
> With respect to Federal budgetary practices, the Commission's principal recommendations called for (1) continued use of performance budgeting, (2) formulation and administration of agency budgets on a cost basis, (3) annual appropriations based on accrued expenditures, and (4) authorizations for limited periods of continuing Government programs not susceptible to the usual budget controls.[2]

Fundamental to the Commission's recommendations was the fact that they did not feel the obligation-type budget showing functional programs was an effective financial management instrument for controlling the cost to be incurred in

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[2]Document No. 11, Financial Management in the Federal Government, op. cit., p. 52.

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carrying out the programs of the government. The feeling was expressed that there had been considerable progress made in the area of financial management improvements through the Joint Accounting Improvement Program, but that the progress had not been fast enough or proceeded far enough. In addition, the Commission felt that the leadership in the development of effective financial management belonged in the executive branch of the government. Up until this time, the General Accounting Office had provided most of the leadership through the Joint Accounting Improvement Program. In considering the executive branch, the Hoover Commission logically felt that the leadership should be vested in the Bureau of the Budget, and so recommended:

> That the Bureau of the Budget expand and make more effective the discharge of its managerial and budgeting functions;
>
> That there shall be established under the director of the Bureau of the Budget a new Staff Office of Accounting headed by an Assistant Director for accounting, with the powers and duties as follows:
>
> (a) To develop and promulgate an overall plan for accounting and reporting, consistent with broad policies and standards prescribed by the Comptroller general. These broad policies and standards should continue to be developed in cooperation with the executive branch.
>
> (b) To expedite, guide, and assist in the introduction of modern accounting methods in the executive agencies consistent with the overall plan.
>
> (c) To set reasonable but definite time schedules for the performance and to watch progress.

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(d) To stimulate the building of competent accounting and auditing organizations in the executive agencies and to assist actively in the selection, training, and retention of capable personnel.

(e) To report at least annually to the Budget Director with respect to the status of accounting in each of the executive agencies.[3]

The importance attached to the Hoover Commission's recommendations by the administration is clearly seen in the following quotations from an exchange of correspondence between Mr. Percival F. Brundage, Director of the Bureau of the Budget, and President Dwight D. Eisenhower in April 1956:

Dear Mr. President:

. . . The Commission's Budget and Accounting Report highlights significant problems of financial administration in the Government and sets important and desirable objectives. The Commission is to be commended for doing its excellent job.

Many of the recommendations endorse constructive efforts which were started following the reports of the first Hoover Commission. The report also supports to a marked degree the current efforts of the Joint Accounting Improvement Program conducted by the General Accounting Office, the Treasury Department, and the Bureau of the Budget, with the participation of the executive departments and agencies. While approving our work, the Commission suggested additional emphasis and greater concentration of effort in order to bring about more rapidly desirable improvements in budgeting, accounting, and management generally.[4]

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[3] Commission on Organization of the Executive Branch of the Government, Budget and Accounting, A Report to the Congress, June 1955, pp. 7, 10.

[4] Improvement of Financial Management in the Federal Government, op. cit., Appendix II, p. 19.

Dear Mr. Brundage:

> . . . The Hoover Commission's Report on Federal budgeting and accounting is a document of great public significance.
>
> . . . I consider it desirable and necessary that the executive departments and agencies intensify their efforts . . . to establish budget and accounting systems that will provide better financial information and enable both the improvement of our budget presentations and the strengthening of our budget controls. In addition, I approve of your plans to have the Bureau of the Budget give greater emphasis in its work to the evaluation and advancement of administration in the executive agencies, as a means of more rapidly bringing about improvement in organization and management, including more effective budgeting and accounting practices, throughout the executive branch.[5]

Public Law 863

Congress acted upon the recommendations of the second Hoover Commission by passing Public Law 863, which amended the Budget and Accounting Act of 1921, to include in the annual budget information on program costs and accomplishments. Cost-based budgets were required as the basis for the development of agency requests for appropriations to the extent deemed desirable and practicable by the President. The law also provided that for the purposes of administration and operation cost-based budgets shall be used by departments and their subordinate units, or, in other words, by all agencies in the day to day operation and control of their operations. Finally, the law provided for a simplified

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[5] *Ibid.*, p. 20.

allotment pattern.[6]

Public Law 863 also amended the Budget and Accounting Procedures Act of 1950, to provide:

> The head of each executive agency shall, in consultation with the director of the Bureau of the Budget, take whatever action may be necessary to achieve, insofar as is possible, (1) consistency in accounting and budget classifications, (2) synchronization between accounting and budget classifications and organization structure, and (3) support of the budget classifications by information on performance and program costs by organizational units.
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> As soon as practicable after the date of enactment of this subsection, the head of each executive agency shall, in accordance with the principles and standards prescribed by the Controller General, cause the accounts of such agency to be maintained on a accrual basis to show resources, liabilities, and the cost of operations of such agency with a view of facilitating the preparation of cost-based budgets. . . .[7]

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[6] Public Law 863, 84th Cong., 2d Session, Chapter 814, S. 3897.

[7] *Ibid*.

CHAPTER IV

IMPLEMENTATION OF COST-BASED BUDGETING

Implementation of cost-based budgeting must be considered from the point of introduction of the first major phase of this concept--the authorization of the performance budget by the Budget and Accounting Procedures Act of 1950, and the endorsement by the Congress of the Joint Financial Management Improvement Program. This act more specifically identified the role of the Bureau of the Budget in the area of financial management in the government. The Act provided that the maintenance of accounting systems and the development of financial reports were the responsibility of the executive branch; that emphasis should be placed on effecting orderly improvements toward more effective financial management practices; and that the Treasury Department, the General Accounting Office, and the Bureau of the Budget should conduct a continuous program for the improvement of accounting and financial reporting.[1]

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[1] _Improvement of Financial Management in the Federal Government_, _op. cit._, p. 2.

The Role of the Joint Accounting Improvement Program

The interrelationship of budgeting, accounting, reporting and other financial management functions in the operations of the government necessitated the establishment of a joint program to improve accounting in the Federal Government. This started as a cooperative program in December of 1947, under which the Bureau of the Budget, General Accounting Office, and the Treasury Department, each having responsibilities in the financial management field, joined together for the purpose of developing more effective and economical accounting practices. It was agreed that all three central agencies would work in cooperation with the administrative agencies, to develop financial improvements throughout the government. The fundamental concepts of the Joint Accounting Improvement Program were stated as follows:[2]

> 1. The maintenance of accounting systems and the production of financial reports are, and must continue to be, functions of the executive branch.
>
> 2. The accounting, budgeting and reporting systems of the executive branch must give recognition to the needs and responsibilities of both the legislative and executive branches.
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> 3. Effective attainment of these objectives requires close working relationships among the General Accounting Office, the Bureau of the Budget, the Treasury Department, and the operating

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[2]In December 1959, in recognition of the full scope of the program, the name was changed to The Joint Financial Management Improvement Program. Annual Report of the Joint Financial Management Improvement Program for Fiscal Year 1959, Letter of transmittal dated 15 December, 1959.

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agencies.

4. There must be an audit independent of the executive branch which will give appropriate recognition to existing features of internal control, including internal audit. Proper accounting, budgeting, and reporting systems are important factors in the effectiveness of such an independent audit.[3]

The foregoing brief description of the founding and objectives of the Joint Financial Management Improvement Program is important to the later development of cost-based budgeting, as it was logical for this program to broaden in scope to encompass all elements of financial management in the government. The broadening of the scope of the program from the original effort was evolutionary in character developing from the changing emphasis of the Joint Financial Management Program activities.[4]

Too much emphasis cannot be placed on the role of the Joint Financial Management Improvement Program (hereinafter called the Joint Program) in fostering improvement in financial management in the Federal Government. The Budget and Accounting Procedures Act of 1950, provided legal recognition of the Joint Program and through later legislation, such as Public Law 863, Congress enacted subsequent laws which established

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[3] The Joint Program for Improving Accounting in the Federal Government, op. cit., p. 2.

[4] The original efforts of the program were based on cooperative agreements expressed in a joint policy statement issued in January 1949 by the Secretary of the Treasury, the Controller General, and the Director of the Bureau of the Budget.

further guidelines in the area of government financial management. The objective of the Joint Program, as it is constituted today, is the improvement of financial practices throughout the government in a manner that will satisfy the management needs of the executive and legislative branches and the existing requirements of law. The current objectives are defined as:

1. Strengthening of agency organization and staff facilities to provide for the most effective conduct of agency financial management.

2. Establishment of effective agency accounting systems on an accrual basis to the fullest extent this accounting basis is appropriate.

3. Establishment of monetary property accounting as an integral part of agency accounting systems.

4. Establishment of cost-based budgeting practices effectively integrated with the accounts to provide adequate support for budget requests.

5. Simplification of agency appropriation and allotment structure, and development of the most effective methods of control of appropriations, funds, obligations, expenditures and costs.

6. The use of consistent classifications to bring about effective coordination of agency programming, budgeting, accounting, and reporting practices.

7. Establishment of suitable internal control practices, including internal audit, in the agencies.

8. Effective integration of agency accounting and reporting with the requirements of the budget process and the central accounting and reporting of the Treasury Department.

9. Development of accurate and useful agency and Government wide reports on fiscal status, financial results of operations, and cost of agency performance of assigned functions.

10. Education of personnel in effective maintenance and maximum utilization of these management tools to effect economy in government operations.[5]

It is well to emphasize here that under the Budget and Accounting Procedures Act of 1950, the responsibility and the initiative for accomplishment of financial improvements to meet the requirements of law rest upon the head of each agency. Legislation has been provided by the Congress, and policy guidance has been provided by the President to spell out the manner for financial management improvement. The basic problem, then, becomes one of implementation, and it is here that the Joint Program provides guidance and assistance to agencies to make the necessary financial management improvements to meet the requirements of the law.

It should be evident at this point that cost-based budgeting is a requirement under the law. Initially, performance budgets were required for the Department of Defense by the National Security Act Amendments of 1949, and for all other agencies of the Federal Government by adoption of the performance budget recommendation of the first Hoover Commission in the Budget and Accounting Procedures Act of 1950. Next, cost-based budgeting and accrual accounting were required by Public Law 863. There is no choice about the type or nature of the budget to be used in the Federal

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[5] Document No. 11, Financial Management in the Federal Government, op. cit., pp. 42-43.

Government, as the Law is clear. All agencies are required to operate on the basis of cost-based budgets with accrual accounting, and the President, in his discretion, shall present the agency budgets to Congress in terms of cost.

Understanding the legal basis for cost-based budgeting and the responsibility for its implementation by the agency head, with the cooperation and coordination of the Joint Program, it is now possible to discuss the implementation of cost-based budgeting on a government-wide basis. This discussion is based primarily on the experiences of Mr. Frank Krause, Staff Member of the Bureau of the Budget, Office of Financial Management.[6]

Bureau of the Budget's Role in Implementation of the Performance Budget

Based on the recommendations of the first Hoover Commission, the Bureau of the Budget initiated the first step in implementation of the performance budgeting concept in 1949.[7] This was started by attempting to develop the programs and activities for each appropriation contained in

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[6] The source of this information was an interview with Mr. Frank W. Krause on November 9, 1962, and his lecture to the Navy Financial Management Class, The George Washington University, on December 11, 1962. Mr. Krause has served in the Federal Government since 1935, and has been with the Bureau of the Budget since 1944. He has been through the installation of cost-based budgeting from its inception.

[7] Krause, loc. cit.

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the budget document. For that purpose, a committee was established in the Bureau of the Budget initially to review the functional responsibilities of each agency. Programs and activities were jointly worked out with each agency, and they were the basis for the development of the first performance budget presented to Congress in the winter of 1950.

The House Appropriation Committee report of the first performance budget was both caustic and critical. Upon questioning the agencies as to the basis of their estimates, they found that only a few of them could tie their estimates back to their accounting systems, or in other words, that the estimates were "pulled out of the air." Typical of the reaction was this statement in the House Appropriations Committee report:

> In its full fruitation it is hoped and expected that better presentation of data will enable the Congress to appropriate more intelligently and provide funds more nearly in line with actual requirements. This can be accomplished only if budget data are so directly related to the accounting data available in the agencies as to make a close check on cost of operations. Some of the schedules in the 1951 budget meet this test. Others are so written as actually to result in lessened facility by the Congress as compared with the old system. Some of the schedules are so drawn as in reality to make budget justification notes submitted in support thereof purely a series of essays with price tags attached.[8]

On the basis of this initial review, Congress directed the Bureau of the Budget, assisted by the General Accounting

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[8]U. S. Congress, House of Representatives, Report No. 1797, General Appropriation Bill, 1951, 81st Congress, 2nd Session, March 21, 1950, p. 10.

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Office, to survey all of the agencies to determine the degree of accounting support that the individual agencies had for their estimates submitted to Congress. Congress stated that if this were not taken care of prior to the submission of the FY 1952 budget, there will be a return to the obligation-type budget presentation.[9]

The Joint Program was the logical means to undertake the surveys for Congress, as this effort was a logical extension of efforts to develop effective financial management within the government. Subsequent to the House Appropriations Committee report directing these surveys, joint teams generally consisting of the agency examiner from the Bureau of the Budget, a representative from the General Accounting Office, and a representative from the individual agency, were designated to make a survey of the budget and accounting activities of each agency. Reports were prepared to show how the agencies formulated their budgets, how they executed their budgets, and how their accounts tied into the budget classifications. Finally, recommendations were made as to what should be done to improve the financial management systems of the agencies.

Copies of these reports went to the House Appropriations Committee, and they showed widely varying degrees of support for the agency budget estimates. In some agencies there was direct support, in others there was little or no support, and in most of the agencies there was spotty support for their

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[9]*Ibid*., p. 11.

budget estimates. This was occasioned by the fact that most agencies had been maintaining their accounts on the basis of object and expenditure rather than in terms of functions and activities.

The agencies which had been maintaining their accounts solely in terms of object and expenditure had to make an across-the-board proration of their estimates to align these object and expenditure costs with their programs and activities under the performance budget concept. This situation resulted in little or no support for the budget estimates of such agencies. Other agencies had been maintaining their accounts by organizational units, and where these organizational units were consistent with the newly established functions and programs, there was generally adequate support for their budget estimates. In a few agencies where programs and activities had previously been established and were supported by the agencies accounting system, there was good support for budget estimates.[10]

Bureau of the Budget's Role Strengthened

With the enactment of Public Law 863, the implementation of cost-based budgeting entered into its second phase; the first phase, performance budget implementation, was previously discussed as being the period 1950-55. As a result of the strengthening of the Bureau of the Budget's role in the area of government-wide financial management, the Office of Account-

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[10]Krause, loc. cit.

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ing (redesignated in 1960, as the Office of Financial Management) was established in the Bureau to carry out this function. With the cooperation of GAO and the Treasury Department, this new office assumed the responsibility for providing executive branch leadership in the improvement of financial management throughout the government, and with a small increase of staff to approximately 20 members undertook its first major project by starting a government-wide program for the improvement of financial management. The Budget Director, at that time, concluded it would be best for the Bureau to begin on a small scale and to depend on the agencies to carry out the systems work necessary to adopt cost-based budgeting and accrual accounting. The small staff of professionals in the Bureau of the Budget were used in an organizing and coordinating capacity.[11]

The major objective and emphasis of the government wide financial management program was to implement the recommendations of the Second Hoover Commission enacted into law by taking such coordinating action as necessary with respect to the financial management systems of the agencies to bring them into alignment with existing legislation. Bureau of the Budget Bulletin 57-5 was issued in October, 1956, to initiate the government-wide program. With this bulletin was transmitted a pamphlet detailing policies to be followed by the executive agencies. Each agency was requested

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[11]Krause, loc. cit.

to initiate a review of its own budgeting and accounting systems in relation to existing legislation, to determine what was needed to bring them into conformance, and to establish a timed phased program for accomplishing this fact. Each agency was to submit such a plan of action to the Bureau of the Budget for review under the Joint Program. These initial submissions were made in the period from October 1956, to the middle of 1957.

The conversion of the Federal Government to cost-based budgeting and accrual accounting was not viewed as a short-range project nor as a panacea. There were and still are immensely complex problems that had to be worked out in the larger agencies, such as the Department of Defense and State Department. The long-term nature of the full implementation of the Second Hoover Commission recommendations was early recognized by the Bureau of the Budget, and is evident from its initial study of these recommendations:

> Full implementation of many of the basic recommendations will not be accomplished overnight because, as the Commission recognized, the changes needed in agency accounting systems are essentially of a long range nature. Furthermore, action on a number of the recommendations is primarily dependent upon acceptance by the Congress.[12]

In keeping with the long-range nature of the program to convert to a cost-based budget supported by an accrual

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[12] Improvement in Financial Management in the Federal Government, op. cit., p. 21.

accounting system, the Bureau of the Budget has been requesting annual reports from the agencies on the status of their programs. The purpose of this reporting process is to allow the three central agencies to keep in touch with the individual agency programs, and to allow the Bureau of the Budget to prepare an annual government wide report showing the progress of this endeavor.

The following table shows the overall progress on the use of cost-based budget presentations since the passage of Public Law 863:

TABLE 2

GROWTH OF COST-BASED BUDGETING[13]

Budget Year	No. of Appropriation Items on a Cost-Based Budget
Prior 1958	4
1958	46
1959	98
1960	139
1961	353
1962	424

[13] Krause, loc. cit.

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CHAPTER V

PROBLEMS IN COST-BASED BUDGETING IMPLEMENTATION

The implementation of cost-based budgeting through the Joint Program has made substantial progress since the adoption of performance budgeting in the government. Progress has not been made without incurring problems, however, and the problem areas may be broadly identified as resulting from: (1) The Bureau of the Budget's secondary role in the field of financial management improvements through the performance budget phase 1950-56; (2) confusion as to what Congress actually wants in budget requests for appropriations; (3) footdragging on the part of some agencies to convert their budgeting and accounting systems to comply with PL 863; (4) lack of proper understanding in government as to the difference between cost-based budgeting and accrued expenditures.

Bureau of the Budget's Secondary Role

Until the recommendations of the second Hoover Commission were made to strengthen the role of the Bureau of the Budget in the field of financial management improvements in the government, the General Accounting Office had been

providing the leadership in this area by default. When the second Hoover Commission made its examination, it was said that the Joint Program was spearheaded by the Controller General and his systems division, and the Bureau of the Budget and the Treasury were the tails of the kite; the Controller General deserves all of the credit that should go to this program.[1] The Joint Program grew out of the great number of problems which had developed during World War II, in which there were differences of opinion among the three central agencies (Bureau of the Budget, General Accounting Office, and the Treasury Department) as to the direction the government should move in the financial management of the agencies. Because of the differences, and because each of the central agencies had certain responsibilities in the area of financial management, they tended to go their separate ways, leaving the operating agencies with a myriad of conflicting and confusing instructions.

After World War II, the continued growth in the size and scope of government operations gave rise to an increasing number of agency management problems. The pre-war methods of financial management were outdated, and this general situation made it evident that the government needed financial information which would accurately reflect fund requirements and the status

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[1]Statement of Mr. J. Harold Stewart, Chairman, Task Force on Budget and Accounting, Hoover Commission. Budget and Accounting Hearings, 84th Congress, 2nd Session, op. cit., p. 29.

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and cost of government programs. It was in this atmosphere that the three central agencies entered into a mutual program for the improvement of financial management in the government. This, then, became the Joint Accounting Improvement Program, and through a committee arrangement an avenue of communications was established to resolve common problems on a cooperative basis. The early emphasis of this program was in the area of government accounting, and since the General Accounting Office had legislative responsibility for agency accounting practices, they took the lead by establishing an accounting systems division, which had at its highest employment level approximately 100 people. This division, unlike the other parts of the General Accounting Office, did not look to the audit or legislative side of watchdogging government expenditures, but rather concerned itself with assisting the operating agencies in improving their accounting systems. In the early days of this program, General Accounting Office personnel generally were in the agencies, working directly with the agency staffs on their accounting systems problems. In contrast to this effort the Bureau of the Budget had a staff of approximately seven working not only on this project, but also other projects of a government-wide nature. Thus, the executive branch, through the Bureau of the Budget, made but a small staff contribution to the activities of the Joint Accounting Improvement Program in the agencies. This situation was what the second Hoover Commission was referring

to when they recommended:

> That the Bureau of the Budget be revitalized so that it could more effectively discharge its overall managerial responsibilities for the executive branch, that specialists in the Bureau be assigned to important agencies to conduct a continuous year-round on-the-spot review of the respective agencies' budget preparations, accounting, financial, reporting, and other facets of the budgetary processes, and that, if necessary, the Congress increase the appropriation of the Bureau for assignment of this highly specialized staff.[2]

The Hoover Commission felt that the leadership of this program belonged in the executive branch of the government, where the Bureau of the Budget was in a position to exercise greater influence on the operating agencies through the power of the President.

The Joint Program was successful to the degree that it brought about a unified approach to the solution of financial management problems and it was used as the means to coordinate the development of accounting and performance budgeting in the operating agencies after the passage of the Budgeting and Accounting Act of 1950. It was not, however, until the passage of Public Law 863, and the redefinition of the role of the Bureau of the Budget in the area of financial management that the Joint Program took a full scale organized approach to the establishment of modernized financial management systems in all agencies. By no means can the full

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[2] Document No. 11, Financial Management in the Government, op. cit., p. 61.

credit be given to the Hoover Commission or the Office of the President for the ultimate reshaping of the Bureau of the Budget and resulting improvement in the Joint Program operations, for it was through the deep interest in Congress in the development of effective management that the necessary legislation was enacted to establish the legal foundation for our current system.

It can be seen then, that the early efforts of the Joint Program were primarily aimed at accounting improvements, and that the executive branch did not have the leadership necessary for the best results. Since 1956, under the active direction of the Bureau of the Budget, the Joint Program has made better progress toward the objectives of improving financial management on a government wide basis.

The second broad problem area encountered in the implementation of cost-based budgeting has been centered in the area of legislative review.

Confusion in Congress

There has been a tendency for Congressional appropriation committees to not know what they want in the way of a budget, and once a change has been put into law, they do not, then, know what they have.

There have been reactions from the appropriations committee on cost-based presentations which have been unfavorable as well as favorable. Part of the problem is that they do not understand cost-based budgets, and another part of

the problem is that they do not want to get involved in the details that appear to be encompassed in such a presentation. Typical of the adverse reaction has been that of the Public Works Subcommittee, which on two succeeding years in its report, reacted unfavorably to the Bureau of Reclamation and Corps of Engineers cost-based budget presentation. In one subcommittee report it was stated:

> As stated in last year's report the cost-type budget is clearly of no value to the Committee in its review process and certainly no assistance in curtailing unnecessary expenditures or appropriations. The task of converting the budget is a waste of time. The Committee is entitled to a budget presentation which does not obscure and confine the amounts of money for which the Federal Government is going to obligate in a given period of time.[3]

The Bureau of the Budget modified the President's budget presentation to satisfy this complaint by taking the program and financing statement, which is the primary schedule, and showing only obligation figures on this schedule, with the full cost back-up included in the budget narrative. This provided the detailed cost estimates for each functional program for those in Congress who want to review this type of information, and provided just the figures on obligation totals for those who did not want to be concerned with program details.

The cost of performance aspect of budgeting was

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[3] U. S. Congress, House of Representatives, Report No. 1864, Public Works Appropriation Bill 1959, 85th Congress, 2nd Session, June 9, 1958, p. 3.

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considered by the first and second Hoover Commissions to be just as much of a benefit to Congress for review of agency operations as it was a benefit for the agency in formulation of the budget and operation and control of its programs. There are elements in Congress who still refuse to use the program cost information in making their own decisions. They are turning their back on information which has been developed and presented by agencies to allow them better to make more meaningful evaluations of the agency programs and operations. The cost table for the Bureau of Reclamation construction program, for example, shows the total estimated cost of a project, the cost to date, the cost of each of the three years in the budget, the cost of inventories on hand, the obligating authority needed for the coming year, and the obligating authority needed to complete. On one line the complete financial picture of that project is disclosed.

Many of the people in Congress who do not like this new type of presentation have been there a long time and are used to operating with tables which showed the objects to be bought, the number of clerks to be staffed in the typing pool of X agency, and they just do not want to change their method of review. One Congressman, when looking at the Army's performance budget, said it was the worst travesty of budgeting that he ever saw and that he could no longer understand anything.[4] Where he used to know what the Army was doing,

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[4]Krause, loc. cit.

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this performance budget was hiding things. This type of reaction has by no means been universally predominant in Congress; however, there has been a reluctance to accept the changes which were meant to give Congress more disclosure of information for better decision making.

Footdragging in Implementation

A third problem area in the implementation of cost-based budgeting has developed in the second phase of the program, the government wide conversion to a cost-based budgeting and accrual accounting. Again it is stressed that the budget required today by law is a performance type, cost-based budget, and all agencies are required to convert to an accrual accounting system to support this type of budget presentation. Yet, there has been evidence of footdragging on the part of some agencies, due possibly to the fact that they think it is something they can do if they want to. A clear understanding of the responsibilities of all agencies is obtained from the following quotation from a Bureau of the Budget publication:

> Public Law 863 specifically requires that each executive agency develop accrual information in its accounts as soon as practicable. The degree to which the accrual basis is applied in individual agencies will vary with the kind of operations conducted by the agency, and significance and materiality of the items in relation to the needs of management for accrual or cost information. At a minimum, it is required that costs must be developed at least by organization units and budget activities, and this may be done on a periodic basis. The objective is to

> apply the accrual basis in each case to the extent that the additional information obtained will be more useful to agency management, and provide better disclosure of financial status and operational results to the various levels of management in the government. Thus, there are no exemptions from accrual accounting under current standards, but there is recognition of a need of varying degrees of application in individual agencies.[5]

The requirements are clear and regular follow-up on agency implementation of those requirements is made through the annual reports requested of the agencies by the Bureau of the Budget. In each report required of the agencies they submit information on the status of their program in terms of meeting the requirements of the law. In the last report, as of the end of Fiscal Year 1962, approximately 83% of the agencies reported installation of accrual accounting systems, and approximately 78% reported conversion to cost-based budgeting. This represents good progress on the surface, but examinations by the Bureau of the Budget and General Accounting Office audits tend to show these figures are not completely reliable. A number of agencies which have not attained those objectives report a target date for completion of their program, and each succeeding year put the target date back one year.[6] At this point, it is well to remember that the agency head, not the Bureau of the Budget, is

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[5] The Joint Program for Improving Accounting in the Federal Government, op. cit., p. 15.

[6] Krause, loc. cit.

responsible for installing and maintaining his own budgeting and accounting system in accordance with the requirement of the law, and in accordance with the principles and standards set forth by the Controller General. The Bureau of the Budget, on the other hand, is responsible for coordinating and stimulating action, and providing guidance and assistance where necessary to help the agencies attain this objective.

Another form of footdragging is carried on by those agencies which report completion of their program, and actually submit cost-based budget requests to the Bureau of the Budget. General Accounting Office audits have pointed out that the accruals established are not adequate nor complete for some agencies operations, and in other cases that agencies have a good accrual accounting system supporting their cost-based budget presentations, but that the information is not actually used as a control device for financial control of operations. It is possible, then, for an agency to report complete, but operate during the year as they have done under the obligation-type budget, and present the cost-based budget annually merely to conform to established presentation requirements. This, of course, negates the advantages gained through use of an integrated cost budgeting process from agency formulation through Congressional review to agency execution.

This type of budgeting operation is not what is required by law, it is not what was intended by the Hoover

Commission, and it definitely is not what is wanted by the executive branch. Through the Joint Program, these discrepancies are being found, and action is being taken to correct them. This will continue to be a long process, and the date for effective completion of the government's modernization program is not yet in sight.

A situation which cannot be classified as footdragging, yet one that bears mentioning, is the case of the Department of the Defense. The Department of Defense does not use a cost-based budget, though it does use the performance concept with an obligation type of budget. This is a large agency, with numerous departments, and it has been found to be difficult to implement the cost-based budgeting program. There are many complex problems in adapting cost-based budgeting and accrual accounting system to their operations. The Bureau of the Budget has had seven people assigned to Defense to assist in conversion. When this program was started in 1956-57, the plan of action called for fact finding surveys, issuance of defense directives and implementation of these directives in each of the five functional appropriation areas. This constituted a well thought-out plan that was to schedule conversion to the cost-basis as soon as possible, and the Bureau of the Budget and Defense personnel made substantial progress. The plan was carried through to the point where surveys had been made in all five of the functional appropriation areas and directives had been issued in three of the five,

Operations and Maintenance, Military Construction, and Military Personnel. There was a submission of implementation plans in the area of Operations and Maintenance, but this was brought to an abrupt halt when the Department of Defense shifted to the development of the program package concept for the 1963 budget. This change by Defense was endorsed by the Bureau of the Budget, since this put the Defense budget on a program basis for the first time. This, however, had the effect of deferring the plan for development of accrual accounting and cost-based budgeting. The two programs will now have to be phased together to satisfy the requirements of the law, which will ultimately have to be met.

A brief insight into the objectives of the defense programming concept, how it is related to accrual accounting and cost-based budgeting, and how the two concepts may ultimately be combined is given in the following quotes from a recent article by Mr. Charles J. Hitch, Controller of the Defense Department:

> Parallel with these efforts to bring the accounting system abreast of the new innovations in programming, we also plan to improve and expand our cost (or expense) accounting efforts. There is a critical need at various levels of management for better cost data. Whether it be the cost of a squadron of MINUTEMAN missiles or the cost of handling a ton of aircraft spares at a depot, precise, up-to-date unit costs are essential for good estimating and decision making. It is this feedback of cost information that permits us to validate and improve our cost estimating, and this is an area which is

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sorely in need of improvement.[7]

Note, here, the reference to the prime importance of actual cost data for better financial management. This is an advantage of a cost system and is one of the most important objectives attained when an agency uses cost-based budgeting and an accrual accounting system. Mr. Hitch recognizes the importance of costs to an effective financial management system, but rationalizes that a complete, integrated accrual accounting system is not required to collect the necessary costs to gain this advantage. In stating his position on this matter, he wrote:

> Cost systems will not normally be required for all activities financed by any one appropriation, or in support of an entire element in the program system. Cost systems, however, will be required for all areas where they will be useful to operating management in accomplishing its functions. Accordingly, cost systems need not be integrated with the appropriation and fund accounts. They may include systems utilizing standard costs and other conventional cost accounting techniques. And they may also be supplemented by special cost studies where continuous recording and reporting of costs are not required.
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> I realize that this approach may be considered by some as not completely responsive to the requirements of Public Law 863 and Bureau of the Budget Bulletin No. 57-5. But, I believe that the objectives that we are seeking are the same as those which under lie the concept of cost-based budgeting and accrual accounting--namely: the relating of costs to performance. The essential difference is the level at which the concept is applied. In our programming system we are trying to provide a sound basis for

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[7]Charles J. Hitch, "Management of the Defense Dollar," <u>The Federal Accountant</u>, Vol. XI (June, 1962), p. 42.

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> evaluating the cost and effectiveness of alternative weapons systems. The programs we are dealing with involve substantial outlays projected over a period of years. The principal "cost" that interests us is "total cost to completion." Costs, therefore, may be viewed in broad terms. For example, total obligational authority programmed over a period of years can be used as a measure of cost. Actually the accounting definition of cost as used in the Federal Government, when applied to a program over a period of years would result in about the same end-cost figure as that obtained from the total obligational authority programmed for the same period of years.
>
> Cost-based budgeting and accrual accounting deal primarily with costs over a shorter time period and with the performance of all of the many tasks which may go to make up an effective fighting machine. The program system is concerned with costs over a longer period of time and with performance in terms of acquiring and deploying the forces and equipment in accordance with program goals and plans. Both objectives are important, but we believe first attention must be given to the accounting needs of our programming system. We must not only have a system to validate our cost estimates, but we must know how our programs are progressing in financial as well as physical terms. When we have satisfied this urgent need, we will be able to take another look at the problems involved in moving toward cost-based budgeting and accrual accounting.[8]

Mr. Hitch's statement that some people may not consider the new Defense approach entirely responsive to Public Law 863, appears to be further rationalization on his part, for it clearly does not meet the requirement for an integrated cost-based budgeting and accrual accounting system. There is no denying that the defense program package concept is a giant step forward. It puts the military on a

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[8] *Ibid.*, pp. 42-43.

true performance budget for the first time, since the requirement for a performance budget was enacted into law for the Department of Defense by the National Security Act Amendments of 1949. Mr. Hitch is not responsible for the Department of Defense's non-implementation of performance budgeting prior to his coming on the scene. He is, however, responsible for the current rationalization of why the Department of Defense is not installing cost-based budgeting and accrual accounting. For example, the essential difference is not the level at which the concept is applied. It is much more basic than that. The systems are not the same in that the defense system will not be uniformly applied nor will it result in the development of information to support a cost-based budget. The key difference still lies in the outmoded obligation concept of control which Mr. Hitch states in the long run is basically the same as cost. This is a partially true statement, but the development of the cost of performance between the start and the finish of a long run program is the best basis for good estimating, good performance determination, and sound financial control. Obligation accounting or modifications of this method cannot give as good information as a uniformly applied accrual accounting system during the life of the project. This contention is supported by Jesse Burkhead's statement on performance budgeting:

> In the development of cost figures which make up a performance budget, all costs should be included. Ideally, this requires an accrual

> system of accounting for the measurement of past program costs, and the estimates on an accrual basis for the budget year. In turn, this would mean that inventory should be maintained on an accrual basis and that portion of capital equipment used up in each fiscal year should be charged to the performance cost for that period.[9]

In summary, the Department of Defense does not fall into the category of "footdraggers" in the conversion to cost-based budgeting and accrual accounting. A performance budget in keeping with the Hoover Commission's concept has been installed and this is a giant step forward. Since 1956, good headway had been made in defense, with the cooperation of the Bureau of the Budget, toward accrual accounting as the first step to cost-based budgeting. This has now been sidetracked by the recently installed program package concept (performance budget), but if Mr. Hitch's future plans are carried through, the Department of Defense will eventually move to complete compliance with the requirements of the law, the intent of Congress, and instructions of the executive department.

Confusion between Accrued Expenditures Appropriations and Cost-Based Budgeting

The fourth and last major problem in the implementation of cost-based budgeting has been the confusion between accrued expenditures appropriations, and cost-based budgeting. The

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[9]Burkhead, op. cit., p. 151.

accrued expenditure proposal was concerned with how funds are appropriated and how they are best controlled. The second Hoover Commission pointed out in its report that appropriations are made in terms of obligations, and this left large balances of unused authorizations in the hands of agencies, over which Congress had no effective control. It was stated that the way for Congress to get control was to appropriate funds in terms of the goods and services that an agency intends to receive over the period of the budget year rather than the goods and services they intend to order. The accrued expenditure appropriation was intended to give Congress better control over the financial authority granted to agencies and the program that the agencies were carrying out. As it turned out, this recommendation of the Hoover Commission ultimately resulted in the passage of one of the most controversial pieces of legislation on budgeting and accounting in many years.[10]

The opposition to this legislation came from the agencies as well as Congress. To the agencies it was another control device which they would have to contend with and was therefore unpopular. It was finally determined, however, that the administration would support the legislation in the interest of increased control over the total budget in terms of being able better to control the pieces under individual appropriations. Surprisingly enough, the most opposition to

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[10] Document No. 11, Financial Management in the Federal Government, op. cit., p. 98.

this proposal came from the members of the House Appropriations Committee, as they questioned the strengthening of Congress' control over appropriations by this means.

If the recommendation was adopted, the agencies would have to have authority to obligate, because they could not place an order unless they had the authority to do so from Congress. The recommendation for accrued expenditure appropriations, therefore, involved the use of contract authorizations under which each agency would get the authority needed to order goods in one year for deliveries in successive years. The initial center of the argument in Congress over this recommendation was on the use of contract authority. Whereas the supporters of the proposal cited increased control for Congress, the opponents contended it would not provide the control Congress needed, since contract authority would have to be granted and carried over each year, and the Congress would be in the same predicament as before.[11]

The arguments pro and con on this proposed legislation became emotional at times. The opposition to this proposal blocked its passage as part of Public Law 863 which, as finally enacted, provided for cost-based budgeting and accrual accounting. The supporting elements in Congress, mainly in the Government Operations Subcommittee, agreed that the accrual expenditure appropriation provision be dropped out of Public Law 863, merely to get that financial reform legislation

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[11] Ibid., p. 99.

enacted, and that the matter would be revived the next session of Congress. The next session bills were immediately introduced to provide for accrued expenditure appropriations and the same kinds of arguments again developed.

Typical of the arguments for the bill was this statement by the Honorable Glenard P. Lipscomb, representative from California:

> With such large unexpended balances in the hands of departments and agencies, Congress is not in a position to control the actual expenditures of the Government or the annual budget surplus or deficit in any given year, because the appropriations that it makes specifically for that fiscal year alone do not determine what the executive department can spend in that year.[12]

Also the Honorable Paul G. Rogers, representative from Florida, stated in support of the measure:

> The main purpose of this legislation . . . is to improve management, give more facts, give stricter control to Congress, and actually bring about more businesslike procedures in the running of our Government, . . . what I think should be important to the Appropriations Committee and the Congress is that this bill will actually greatly shift the burden from the Appropriations Committee and Congress to dig out the facts, to have to ask all the questions, to find out what is going on, how the tax dollar is being spent.[13]

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[12] U. S. Congress, House of Representatives, Subcommittee of the Committee on Government Operations, <u>Improving Federal Budgeting and Appropriations</u>, 85th Congress, 1st Session, March 26, 27, April 3, 4, 5, and 10, 1957, p. 20.

[13] <u>Ibid</u>., p. 37.

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A compromise bill was finally worked up to get out of this situation as best as possible. The compromise bill provided that the appropriations would be made in terms of obligations, as in the past, and this would negate the use of contract authorizations, which was the main issue under attack by the House Appropriations Committee. To give affect to the second Hoover Commission recommendation the bill provided that each obligation appropriation should have within its language a limitation on the amount of accrued expenditures that could be incurred during the year by the agency. This had the same effect as the accrued expenditure appropriation proposal in that an agency would be given obligational authority, but the Congress would be able to impose a ceiling on the amount of goods and services that could be received under any appropriation in any budget year.

A compromise bill was passed in 1958, as Public Law 795, but the opponents of this legislation were successful in placing a termination date of April 1962, on the bill which was to be the end of a test period for this procedure. The first year in which the bill was effective the Bureau of the Budget proposed accrued expenditure limitations in six appropriations. Congress dropped the limitations after a revival of the old arguments. The second year the Bureau proposed twelve accrued expenditure limitations and again they were dropped. The third year none were proposed for if approved they would not have been effective a full year before

the bill's termination date of April 1962 arrived, and this would not have been a satisfactory length of time to test their effectiveness.

In April 1962, the accrued expenditure limitation was terminated after two bills to extend it never reached the hearing stage. In summary of this point, it should be remembered that the accrued expenditure limitation was proposed as an adjunct to the cost-based budgeting and accrual accounting reforms for the Federal Government. It was considered to be of prime value to Congress for control of funds used during any fiscal year by an agency under an appropriation. It was presented as a necessary measure for more effective financial control by Congress to go along with the advantages of cost-based budgeting and accrual accounting. The fact that accrued expenditure limitations have not been enacted and the law was not extended does not affect the cost-based budgeting and accrual accounting requirements under Public Law 863. To many people who thought of the two concepts as one and the same, this has been a point of confusion.

CHAPTER VI

CONCLUSIONS

History shows that the Federal Government operated for over a century with less perfect methods of financial control than are currently in use. It must be recognized that the present system of financial management, which is based on budgeting and accounting reforms since World War II, is not the ultimate system or a panacea. The government is presently operating and will continue to operate without full acceptance of many of the reforms which have been introduced subsequent to the reports of the first and second Hoover Commissions. Nevertheless, it is the author's firm conviction that the benefits foreseen by the Hoover Commissions, legislators, businessmen, and professional managers inside and outside the government, which accrue from the use of cost-based budgeting, a financial management reform of singular importance, are both practical and substantive.

Cost-based budgeting and accrual accounting as a means of achieving the objective of improved financial management in the government are just the "tools" or mechanism upon which sound financial management practices can be built. They are beneficial "tools", as demonstrated by their universal acceptance in the business community and certain agencies of

the government; however the "pay-off" in good financial management comes not from the "tools" in themselves, but through their use by the managers and people. One of the largest problems is to get people to understand cost-based budgeting; to understand its advantages and how it offers substantial improvements in all phases of the management process. The operating experience of the Atomic Energy Commission offers ample proof of the benefits of cost-based budgeting. In this agency it provides more accurate information for better management decisions.

The problem of understanding is not just confined to the Executive Branch of the government. The Legislative Branch has many "old timers" who want to continue to review budget requests and make decisions based on the same kind of information that was presented to Congress when the President's annual budget was less than $10 billion dollars. Only education through a number of years' successful use of cost-based budgets and eventual replacement of the "old timers" will create the required degree of understanding of this concept in the Congress.

There is a need for greater control over the conduct of government-wide financial management by the Office of the President. The basis for this greater control exists today in the form of "the power of the President" with direction through his staff arm, the Bureau of the Budget. Greater control over the conduct of financial management will

be difficult to achieve because by the nature of financial management, an administrative problem, it can not compete successfully for the time of the President and his staff with the affairs of state and defense. Therefore, the improvements in government-wide financial management will be more evolutionary rather than revolutionary, and the outlook for continued progress is slow.

Regardless of the many problems encountered in the implementation of cost-based budgeting, it has fulfilled its objectives by providing agencies with more accurate cost information for the review of total resources on hand, on order, and required to complete programs. Budgeting on this basis relates program costs to program responsibilities, thus aligning program and financial management. It provides a comparison of progress with proposed plans, and these plans can be realistically evaluated against funding requirements, considering all of the resources of the agency. Cost-based budgeting, therefore, provides definite advantages which can be the basis for an integrated financial management system in the government which can better reach its potential as a management planning, programming, execution, and control device.

ANNEX A

THE ATOMIC ENERGY COMMISSION'S EXPERIENCE WITH COST-BASED BUDGETING

Background

The Atomic Energy Commission encountered budget presentation problems and budget administration problems which led to the adoption of cost-based budgeting and accrual accounting in 1951. The traditional obligation-type of budget proved to be inadequate for appropriation requests and program management in the A.E.C. In discussing the A.E.C.'s problems in this area, Mr. James A. Miller, Deputy Assistant Controller for Budget, said:

> The development of a cost based budget for the Atomic Energy Commission and the administration of funds on the basis of costs were more a matter of necessity than choice. When the Commission was established, it took over and continued the budget system, based on obligations and expenditures, developed by the Department of the Army. It soon was evident that the traditional allotment system and reports on obligations and expenditures were not an adequate basis for financial control.[1]

The A.E.C. found that the obligation-type budget did not provide the information which reflected the program

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[1] James A. Miller, "Budget Execution in An Agency and System of Administrative Control of Funds," The Armed Forces Controller (September, 1959), Vol. IV, No. 3, p. 28.

accomplishments which could be used for control by management. In addition, the agency estimates were not satisfying the requirements of the House Appropriation Committee for they were deficient in the necessary detail for the Committee to achieve the necessary degree of understanding for sound congressional review and decision making on the agency's requests. The House Appropriations Committee in its report on appropriations expressed their dissatisfaction with the A.E.C.'s budget presentations on the obligation basis.

In the early operations of the A.E.C. the control of operating funds was primarily from the standpoint of monitoring expenditures under management contracts with large industrial firms for the manufacture of nuclear products. The cost accounting systems of each of the many A.E.C. contractors were consistent with their own industrial operations and consequently the costs reported to the Commission were made in various forms. This early system was not coordinated and the reporting of programs on different basis made it impossible to prepare overall reports for the Commission as a whole. As early as 1948, the Commission recognized the need for a uniform cost system and budgetary process. By 1949 a uniform cost and reporting system had been installed under the direction of the A.E.C. controller, Mr. Don Borroughs, and by 1951 the Commission submitted its budget to Congress for the first time on a cost-based basis. The presentation of the Commission's first cost-based budget was, therefore, the result of the

reports of the Appropriation Committees of both House of Congress on the Independent Offices Appropriation Bill, 1950, which had called for the presentation on the Commission's 1951 budget in terms of cost in the interest of clarity, so that performance of programs could be better measured by the uniform accrual accounting system the Commission had recently installed.

The development of an integrated system of budgeting and accounting on a cost basis by the A.E.C. was made in conjunction with the cooperation and assistance of the Joint Accounting Improvement Program. It was one of the early contributions to improved financial management in the Government by a major agency.[2]

The Commission's Reasons for Converting to Cost-Based Budgeting

The Commission considered that a cost-based budget would more effectively meet its requirements than the traditional obligation-expenditure budget based on the difficulties encountered in the functioning of their financial management process on the obligational concept. The Commission felt cost-based budgeting offered the following advantages:

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[2] U. S. Atomic Energy Commission, The Budget Processes of the Atomic Energy Commission. Prepared for the Joint Committee on Atomic Energy pursuant to a letter request dated September 5, 1958 from the Staff Counsel and Acting Executive Director, p. 1. (no date).

(1) It provided the basis for meaningful and descriptive information of the Commission's operating responsibilities with associated fiscal data firmly based on sound accounting support.

(2) It was consistent with the Commission's management contractors operating government-owned facilities in carrying out the bulk of the AEC programs.

(3) It provided annual fiscal measure of the AEC program progress in relation to goals. This assists management in making decisions concerning priorities and alternatives in meeting program objectives.

(4) Accrual accounting provided an accounting system which would develop accurate unit costs of products produced by the Commission as a basis for pricing and charges, and other types of management decisions involving economic alternatives.[3]

Cost-based budgeting at the AEC has been highly successful as a mangement tool. It is a blend of the traditional government-type fiscal accounting and controls with industrial-type budgeting and budgetary controls. The major

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[3] U. S. Atomic Energy Commission, Bureau of the Budget Presentation AEC Financial Management, August 1960, p. 2.

emphasis is placed on program control and measurement of performance in terms of costs. Through the use of this type of a financial management system fund accounting and reporting has been substantially reduced and accounting reports based on arbitrary distributions have been eliminated.

The cost-based budgeting program in the AEC was described by Mr. Robert Hollingsworth, Deputy General Manager of the Commission, as a planning and control instrument for the use of top management to show the level of effort of operations for the coming periods, and the progress that has been made toward the program goals based on sound financial information for past periods.[4] It is considered an invaluable management device for effective program and financial control.

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[4] Interview with Mr. Robert Hollingsworth, Deputy General Manager, AEC, October 26, 1962.

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